
Juggling the Complexities of Trust Distributions

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Darius Hii, Director, CTA
Chat Legal Pty Ltd



Chat Legal Pty Ltd
ABN 64 621 391 553
letschat@chatlegal.com.au
PO Box 74, Underwood, QLD 4119
<https://chatlegal.com.au>



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1 Overview

- 1.1 The landscape of trust distributions in Australia has become increasingly complex due to a series of 2022 legal decisions and evolving guidelines from the Australian Taxation Office (ATO).
- 1.2 These include:
 - (a) The rise in trust disputes, particularly those questioning whether trustee decisions are made with 'real and genuine' consideration. This issue has been highlighted in several recent court cases, where the scrutiny of trustee discretion has intensified. The legal framework surrounding these disputes is evolving, and understanding the nuances of these changes is crucial for effective trust management.
 - (b) Additionally, the ATO's guidance on Section 100A and Division 7A of the Income Tax Assessment Act 1936 (**ITAA 1936**) has significant implications for trust distributions to adult children and bucket companies.
- 1.3 This paper will delve into these and other issues that may arise making trust distributions, including:
 - (a) Managing the mismatch between tax and accounting income and ensuring tax effective streaming of capital gains and franked dividends.
 - (b) Managing Division 7A exposure when the trustee distribution resolution includes a company.
 - (c) What records should be maintained to support tax effective distributions to:
 - (i) adult children
 - (ii) bucket companies
 - (d) How family trust distribution tax is being inadvertently triggered
 - (e) Tips to ensure "real and genuine" consideration has been given to all potential beneficiaries and the tax consequences if it hasn't.
 - (f) How trust distributions today can impact on entitlement to the small business capital gains tax (**CGT**) concessions in the future.
- 1.4 In addition, this paper will include a general trust distribution checklist addressing trust income and capital distribution considerations.
- 1.5 The author notes that each trust distribution resolution requires a careful review of the relevant trust deed as well as consideration of the circumstances surrounding the beneficiaries of the trust to ensure such distribution is valid. Accordingly, appropriate specialist advice should be sought as required.
- 1.6 A reference to ITAA 1997 in this paper is a reference to *Income Tax Assessment Act 1997* (Cth).



2 What is income and ensuring tax effective streaming

2.1 Critical in ensuring effective trust distributions is an understanding on:

- (a) what can be distributed from the trust; and
- (b) how are such distributed amounts taxed (particularly where there is a mismatch between tax and accounting income)?

Net income and distributable income (otherwise known as trust income and occasionally as accounting income)

2.2 Both questions are answered (on their face) under section 97 ITAA 1936:

“(1)...where a beneficiary of a trust estate who is not under a legal disability is presently entitled to a share of the income of the trust...the assessable income of the beneficiary shall include:

- (a) *the assessable income of the beneficiary shall include:*
 - (i) *so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident”*

2.3 From section 97 ITAA 1936, a formula arises whereby:

- (a) Such share of the ‘income of the trust’ to which a beneficiary is entitled to receive is calculated (which we will call **Distributable Income** but can also be known as **Trust Income** and is commonly referred to as ‘accounting incoming’ in trust deeds).
- (b) The beneficiary is taxed on such share of the ‘net income of the trust estate’ that is attributable to such a beneficiary (which we will define as **Net Tax Income** but is also known as ‘section 95’ income).

2.4 As to the meaning of ‘income of the trust’ estate and ‘net income of the trust estate’, the High Court case of *Bamford*¹ established that:

- (a) The phrase ‘income of the trust estate’ in section 97 ITAA 1936 means trust income as determined in accordance with trust law principles (being Distributable Income).
- (b) The ‘share’ of ‘net income of the trust estate’ (being the taxable income derived by the trust known as Net Tax Income) assessed to a beneficiary under section 97 ITAA 1936 is the beneficiary’s proportionate share of Trust Income, rather than any approach based on the quantum of Trust Income received by the beneficiary.

2.5 The facts of *Bamford* relates to the taxation of trust distributions made in two income years.

2000 income year

- (a) In the 2000 income year the trustee resolved to distribute \$34,000 each to Mr and Mrs Bamford with the balance of Trust Income to the Church of Scientology.
- (b) It was subsequently discovered that certain deductions claimed by the trust were not allowable under the tax law which resulted in Net Tax Income of the trust to exceed its Distributable Income.
- (c) The question was how this excess should be taxed under section 97 ITAA 1936.
- (d) The taxpayer argued that they should only be taxed on the amount of Distributable Income actually distributed to them.

¹ *Commissioner of Taxation v Phillip Bamford & Ors* [2010] HCA 10



- (e) In contrast, the Commissioner of Taxation's (**Commissioner**) approach was to include in Mr and Mrs Bamford's assessable income, such proportion of Net Tax Income derived by the trust which was referable to the proportion in which Trust Income had been distributed Mr and Mrs Bamford (known as the proportionate approach).

2002 income year

- (f) In the 2002 income year the only taxable income derived by the trust was a net capital gain.
- (g) Apart from the net capital gain, the trust derived no other Distributable Income.
- (h) The Distributable Income was not defined in the trust deed but included a provision which allowed the trustee to include a capital gain in Distributable Income.
- (i) Using this power, the trustee resolved to distribute the net capital gain to beneficiaries.
- (j) The Commissioner sought to argue that that the concept of Distributable Income was fixed to ordinary concepts and could not include a capital gain.
- (k) As such, the Commissioner sought to assess the trustee on the capital gain at the top marginal tax rate under section 99A ITAA 1936

2.6 As to the question on how the beneficiaries should be taxed on the Distributable Income received, the High Court clarified that the proportionate approach adopted by the Commissioner was the correct approach to adopt in determining a beneficiary's share of Net Tax Income of a trust. In determining this issue, the High Court ended a long running debate as to whether a proportionate or quantum approach to determining a beneficiary's share of Net Tax Income was correct.²

2.7 As to the question on whether the concept of Distributable Income was fixed to ordinary concepts, the High Court determined that the concept of Distributable Income (or Trust Income) takes its meaning from trust law. Distributable Income was therefore determined in accordance with the terms of the trust deed, general trust law and appropriate accounting principles. As a result, the High Court ruled that the Commissioner was wrong to tax the capital gain made by the trust in the 2002 income year under section 99A ITAA 1936. Since the trust deed conferred on the trustee the power to include a capital gain in Trust Income and this had been validly exercised by the trustee, the High Court ruled that the net capital gain should be assessed to the beneficiaries to whom distributions of Trust Income had been made.

2.8 Following the *Bamford* decision, the ATO issued a Decision Impact Statement which is summarised as follows:

- (a) The concepts of Distributable Income and Net Tax Income are two different subject matters which do not necessarily correspond.
- (b) In subsection 97(1) of the ITAA 1936, 'income of the trust estate' (i.e. Distributable Income) takes its meaning from the general law of trusts and not from taxation law.
- (c) Under the general law of trusts the concept of 'income' is governed by a set of rules designed to ensure that trustees fairly apportion the receipts and outgoings of a period between those entitled to income and those with an interest in capital.

² See discussions in *Davis v FCT* 89 ATC 4377, *Richardson v FCT* 89 ATC 5098 and *Zetaforce v FCT* 98 ATC 4681



- (d) Under trust law, there are presumptions about whether particular receipts or outgoings constitute income or capital of the trust but these presumptions can be displaced by express provision in the trust deed.
- (e) The 'proportionate approach' applies in determining a beneficiary's share of the trust's Net Tax Income.
- (f) The proportionate approach is a mathematical calculation based on applying the percentage share that a beneficiary is presently entitled to Distributable Income, to the trust's Net Tax Income.

Streaming of capital gains and franked distributions

- 2.9 The outcome of *Bamford* did force a change in law regarding the taxation of trusts.
- 2.10 Prior to the case, it was largely considered standard practice that trustees of trusts could stream provided the terms of the trust deed allowed for it.
- 2.11 The Commissioner, however, adopted a more stringent position on the proportionate approach, arguing that streaming was not possible on the basis that a beneficiary's percentage of total Distributable Income they were presently entitled to, meant that the Net Tax Income flowed in the same proportion. Such approach did not cater for separate classes of income being set aside and dealt with separately. Rather, beneficiaries were deemed to have received a portion from each different class of income based on their percentage over the total Distributable Income.
- 2.12 Given the ambiguity, the Government introduced streaming provisions in *Taxation Laws Amendment (2011 Measures No. 5) Act 2011 (TLAM5)*. It should be noted that such measures were only intended to operate in the interim until a review of the taxation of trust could be finalised and a rewrite of the rules were undertaken. Unfortunately, as of the date of this paper, no rewrite has occurred and as such the interim measures of TLAM5 are still of effect.
- 2.13 The effect of TLAM5 can be summarised as follows:
 - (a) All capital gains and franked distributions are now assessed to a beneficiary under Subdivision 115-C and Subdivision 207-B Income Tax Assessment Act 1997 (Tax Act 1997) respectively.
 - (b) No other classes of income (such as interest income) are specifically included as being able to be streamed as a separate class of income under TLAM5.³
 - (c) If a trustee wishes to stream capital gains or franked distributions to specific beneficiaries, the process under the TLAM5 amendments is:
 - (i) Start with Division 6 ITAA 1936 – determine each beneficiary's share of the 'income of the trust estate';
 - (ii) Determine amounts of capital gains and franked distributions to which beneficiaries are **specifically entitled** – see below how a specific entitlement arises - and each beneficiary's 'adjusted Division 6 percentage' of the remaining 'income of the trust estate';

³ Subsequent to the enactment of the TLAM5 amendments, the Full Federal Court in *FCT v Greenhatch* [2012] FCAFC 84 endorsed the Commissioner's mathematical approach to applying the proportionate approach. This suggests that outside of the TLAM5 streaming amendments it is not possible to stream other types of trust income differentially as between beneficiaries.



- (iii) Apply the Subdivisions 115-C and 207-B Tax Act 1997 to assess the beneficiaries (or trustee) on their share of capital gain made or franked distributions derived by the trustee; and
 - (iv) Apply Division 6E ITAA 1936 to adjust the taxable income amounts otherwise assessed to a beneficiary (or trustee) under Division 6 ITAA 1936.
 - (d) Capital gain and franked distributions to which no beneficiary is specifically entitled to will be allocated proportionately to beneficiaries using the adjusted Division 6 percentage - being their present entitlement to 'income of the trust estate' excluding capital gains and franked distributions which any entity is specifically entitled to.
 - (e) The balance of the 'income of the trust estate' (after deducting all capital gains and franked distributions), appointed to beneficiaries is assessed under Division 6 but using the adjusted Division 6 percentage. Double taxation is avoided by Division 6E ITAA 1936 eliminating capital gains and franked distributions from Division 6 ITAA 1936.
- 2.14 A crucial aspect in being able to stream capital gains and franked distributions is the need to ensure target beneficiaries are made '**specifically entitled**' to such capital gains or franked distributions.
- 2.15 In order for beneficiaries to be considered **specifically entitled**, beneficiaries must receive or reasonably be expected to receive an amount equal to the '*net financial benefit*' linked to the capital gain or franked distribution in the trust.
- 2.16 Further, the beneficiary's entitlement to the amount must be recorded in its character in the accounts or records of the trust. In addition to needing to have resolutions drafted appropriately; accounts, ledgers and financial statements are required to be consistent with this.
- 2.17 Before considering the impact of such streaming provisions to such Distributable Income of a trust, it is important to appreciate that issues can arise when seeking to link '*net financial benefits*' to the relevant beneficiaries. Such issues can include (but are not limited to):
- Relating to capital gains streaming***
- (a) Ensuring that capital gains revalued as a result of an asset revaluation reserve are tracked over the life of the asset to the target beneficiary.
 - (b) Contracts that fall over two income years may result in a capital gain being linked in the prior income year, but will require additional tracking upon the asset settling in the later income year.
 - (c) Where a capital gain has been made, but the definition of income of a trust deed causes there to be no Distributable Income (perhaps, for example, due to the definition of income being linked to the ordinary concepts of income which would not ordinarily include capital gains), then steps must be made to ensure such target beneficiaries are made specifically entitled.
- Relating to franked distribution streaming***
- (d) Where a franked distribution is fully offset by losses or relevant expenses, then there will be difficulty in making beneficiaries specifically entitled to such franked distributions. This can often be managed by pooling all franked distributions into a single class of income, thus leaving some net franked distribution for distributing.



- (e) Franking credits are not able to be separately streamed as mentioned in paragraph 2.60 of the explanatory memorandum introducing TLAM5.
- 2.18 Much of the above issues may arise where no Distributable Income exists that enables beneficiaries to be specifically entitled to capital gains or franked distributions (due to no excess amount that can be distributed to such beneficiaries).
- The importance in understanding what is Distributable Income***
- 2.19 Back to our initial question in knowing what can be distributed from the income.
- 2.20 Understanding what Distributable Income of a trust for an income year is crucial as the tax flows in proportion to such amounts (subject to any streaming of capital gains or franked distributions). Further, Distributable Income is an important concept in ensuring beneficiaries can be made specifically entitled, to allow for the streaming of capital gains or franked distributions.
- 2.21 As held in *Bamford*, the terms of a trust deed determine what Distributable Income is.
- 2.22 There are limits, however, as issued by the Commissioner in Draft Taxation Ruling TR 2012/D1 on what can constitute 'income of the trust estate' (i.e. Distributable Income).
- 2.23 Specifically, income must be tangible and cannot include notional amounts such as the franking credit gross up, amounts included in assessable under the accrual provisions of transferor trust rules and controlled foreign companies rules, and deemed capital gains arising from the application of the deemed market value capital proceeds rule.
- 2.24 Trust deeds themselves commonly define Distributable Income into one of three categories:
- (a) Distributable Income means income according to ordinary concepts.
 - (b) Distributable Income means section 95 income (or Net Tax Income) less notional amounts.
 - (c) Distributable Income means such amount which the trustee determines.
- 2.25 Where Distributable Income is defined to mean income according to ordinary concepts, then care should be taken when capital gains have been made. In such circumstances, Distributable Income would not include capital gains as being able to be distributed under an income power, and steps would need to be taken to ensure beneficiaries are made specifically entitled through a separate distribution of capital.
- 2.26 Where Distributable Income is defined to mean section 95 income, then only part of a capital gain would be included where the 50% CGT discount applies. Part of the capital gain would still be sheltered and if streaming is required, a separate distribution of capital would be required in tandem with an appropriately drafted classification of the taxable capital gain as a separate income class.
- 2.27 Where Distributable Income means such amount which the trustee determines, then flexibility is offered to trustees to determine the manner in which they wish to define Distributable Income, provided it is within reason.⁴

⁴ A blatant recharacterisation of income to capital is likely to fall foul of the general anti-avoidance provisions of Part IVA Tax Act 1936. In *Forrest v FCT* 2010 ATC 20-163 the Full Federal Court ruled that a trustee could not exercise a broad power to recharacterise receipts and outgoings as income or capital without regard to the terms of the trust. In that case the trust was a hybrid trust with unitholders holding a fixed entitlement to trust income and discretionary beneficiaries who were potentially entitled to distributions of capital gain.



- 2.28 Given the benefits in being able to determine income in a wide range of manners, trust deeds should ideally (but not always) contain additional powers for the trustee to: be able to recharacterise receipts and outgoings as income or capital, account for and deal with separate classes of income and determine whether or not to offset prior year trust losses against current year income.
- 2.29 The importance of a trustee having the ability to determine whether or not to offset prior year trust losses is highlighted due to the traditional rule in *Upton v Brown (1879)* 12 Ch D 872 that prior year losses must be recouped against current year Distributable Income. This power can be useful where there is a disparity between trust losses and tax losses – for instance, a trust fails the trust loss tests and so cannot claim the benefit of prior year losses. If the rule in *Upton v Brown* is not displaced in this situation, it is possible to have a section 99A situation where trust losses reduce Trust Income to nil but there is still positive Net Taxable Income for the trust.
- 2.30 As a final note as to what is being distributed, where trust losses either exist or are required to be carried forward, care must be taken to ensure the trust loss rules of Schedule 2F ITAA 1936 are met and whether a family trust election should be made (which may be of use in additional circumstances; particularly where a discretionary trust wishes to distribute franking credits).⁵

⁵ Without a family trust election for a discretionary trust, franking credits attached to dividends paid are unlikely to be linked to a qualified person. Electing to be a family trust allows the trustee and beneficiaries of such a trust to benefit from franking credits.



3 Trust distributions and managing Division 7A exposure

- 3.1 For company unpaid present entitlements (**UPE**) arising on or before 30 June 2022, the previous long standing ATO guidance of PSLA 2010/4 and TR 2010/3 may continue to apply to those arrangements.⁶
- 3.2 For all other company UPEs from 1 July 2022 onwards, Tax Determination 2022/11 (**TD 2022/11**) outlines the ATO position on when financial accommodation is said to apply for the purposes of Division 7A.
- 3.3 TD 2022/11 provides guidance on when an UPE or an amount held on sub-trust becomes the provision of “financial accommodation” under Division 7A ITAA 1936.
- 3.4 The determination clarifies that an UPE can be considered financial accommodation if it provides a benefit to the trustee, similar to a loan. That is, if a private company beneficiary does not call for payment of its UPE and allows the trustee to use the funds, it is akin to providing financial accommodation.⁷ In coming to this conclusion, TD 2022/11 cites *Corporate Initiatives Pty Ltd v Commissioner Of Taxation* [2005] FCAFC 62 noting that:
- [72] The Full Federal Court also concluded that, by not calling for payment of funds distributed to it, the private company beneficiary with knowledge of the UPE provided a benefit to the trustee who could continue to use the trust funds for trust purposes, and stated that (emphasis added):*
- We therefore think the Tribunal was correct in proceeding on the basis that, **on demand being made by SBS as trustee for CUT, Eldersmede would have to do something to arrange funds for the payment, whether by selling, or borrowing against, available assets, which would then no longer be available for other trust purposes. Not having to do this was a benefit. Eldersmede was thus in a better or more favourable position than it would have been had it been required to fund the distributions.***
- 3.5 This will be the case in circumstances where the same individuals control the private company beneficiary and trustee of a distributing trust. As the same individuals will have knowledge of both the trust and company contemporaneously, a corporate beneficiary will be deemed to have knowledge of an amount equal to the UPE that it can demand immediate payment from whilst choosing not to demand that payment. Accordingly, by ‘not exercising its right to demand payment of the UPE, the private company beneficiary consents or acquiesces to the provision of financial accommodation to the trustee.’⁸
- 3.6 Further, where the same directing minds are involved with the utilizing of sub-trust/sub-trust fund rather than a UPE, the failure to exercise the right to call for payment of the sub-trust fund will also constitute financial accommodation for the purposes of Division 7A.⁹
- 3.7 Appropriately, TD 2022/11 acknowledges that this ‘knowledge’ of the UPE amount will typically only be able to be calculated with sufficient certainty after the end of the income year that the present entitlement arises.¹⁰

⁶ Taxation Determination TD 2022/11 at paragraphs 47 and 48.

⁷ Taxation Determination TD 2022/11 at paragraph 83.

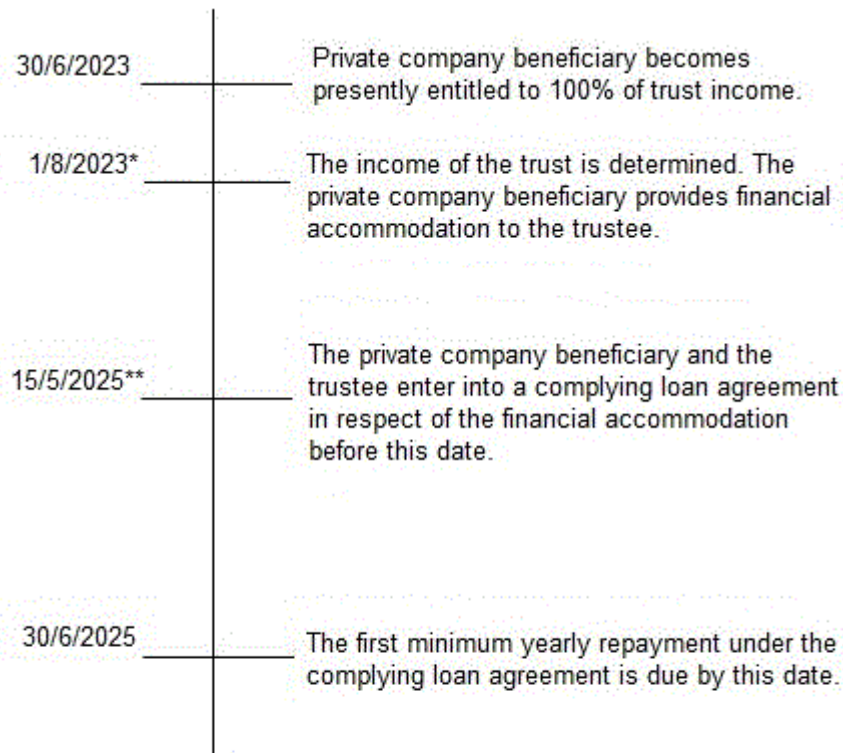
⁸ Taxation Determination TD 2022/11 at paragraph 84.

⁹ Taxation Determination TD 2022/11 at paragraph 85.

¹⁰ Taxation Determination TD 2022/11 at paragraphs 88 and 89.



- 3.8 TD 2022/11 therefore notes that '[i]f a complying loan agreement is entered into in respect of the financial accommodation, the first minimum yearly repayment will be due by 30 June of the year following the income year in which the financial accommodation was provided.'¹¹
- 3.9 In order to enter into a complying loan agreement, the Commissioner will accept that a UPE has been satisfied and replaced with a new loan where either:¹²
- (a) the trustee can pay the trust entitlement to the private company beneficiary and have that amount loaned back under a complying loan agreement, or
 - (b) the private company beneficiary and the trustee can enter into a complying loan agreement and set off their respective obligations; that is, the trustee's obligation to pay the trust entitlement to the private company beneficiary and the private company beneficiary's obligation to fund the loan are set off against each other.
- 3.10 Timing wise, where a company is made presently entitled to trust income by 30 June 2023, the financial accommodation will likely be determined during the 2023/2024 financial year and repayments will need to be made by 30 June 2025 (following a complying loan agreement being entered into before the lodgment date of the company's tax for the year in which the financial accommodation was made (see TD 2022/11 Diagram 2 below):



*Date may be different depending on when the income of the trust is determined for the 2022-23 income year.

**Date may be different depending on the lodgment day of the private company beneficiary's tax return for the 2023-24 income year.

¹¹ TD 2022/11 at paragraph 102.

¹² TD 2022/11 at paragraph 105.



4 Trust distributions and adult children/companies

- 4.1 Taxation Ruling TR 2022/4 (**TR 2022/4**), Practical Compliance Guideline 2022/2 (**PCG 2022/2**) and Taxpayer Alert TA 2022/1 (**TA 2022/1**) outlines the ATO's position in interpreting section 100A ITAA 1936.
- 4.2 Broadly, section 100A is an anti-avoidance provision designed to prevent tax avoidance through trust structures which applies when a beneficiary of a trust becomes presently entitled to trust income under a reimbursement agreement. A reimbursement agreement involves an arrangement where someone other than the beneficiary benefits from the trust income and the arrangement is made with the purpose of reducing tax **and** is not made in the course of an ordinary family or commercial dealing.
- 4.3 TR 2022/4 and PCG 2022/2 provides guidance on what the ATO will consider an ordinary family or commercial dealing.
- 4.4 A detailed analysis regarding section 100A, TR 2022/4 and PCG 2022/2 is outside the scope of this paper, however, consideration will be had regarding what records should be maintained to support tax effective distributions to adult children and bucket companies in light of such ATO guidance.

What is 'ordinary family or commercial dealing' in the context of the ATO guidance

- 4.5 TR 2022/4 notes that whether there is an ordinary family or commercial dealing will depend on all the relevant circumstances which would require considering of the historical behaviour of parties and whether the dealing:¹³
- (a) is artificial or contrived
 - (b) is overly complex
 - (c) contains steps that are not needed to achieve the family or commercial objectives, or
 - (d) contains steps that might be explained instead by objectives different to those said to be behind the ordinary family or commercial dealing.
- 4.6 The ruling notes that the *"test can involve an inquiry into what the objectives of the dealing are and whether the steps that comprise the dealing would achieve that objective. It can also be relevant to inquire whether the dealing or steps within the dealing might be explained instead by objectives different to those said to be behind the ordinary family or commercial dealing. Illustrations can be found in case law:*
- (a) *In Prestige Motors, in concluding that the 3 transactions did not arise out of ordinary family or commercial dealing, the Court referred to the absence of commercial motivation or commercial necessity or justification for the transactions, and observed of one arrangement that the 'only explanation for the entry into the agreement ... [was] the elimination or reduction of tax liabilities'.*
 - (b) *In Guardian FCA, the Court (Logan J) identified an agreement involving the incorporation of a company, the nomination of that company as an eligible beneficiary of a trust that conducted investment activities and the subsequent appointment of income from those investment activities to the company. In concluding that the exception applied, the Court made findings on the evidence and posited that the identified agreement achieved the benefits of 'risk minimisation ... the shielding of distributed income and accumulated wealth from any creditors of*

¹³ TR 2022/4 at paragraph 27.



individuals who were also members of the class of eligible beneficiaries' and the 'familial advantage ... of not having to make a large distribution in an income year to an individual'.

- (c) *In BBlood FCA, in concluding the arrangement was not an agreement entered into in the course of ordinary family or commercial dealing, the Court observed that the arrangement was unusual, was more complex than was necessary to achieve any specific purpose that could be described as 'ordinary family or commercial dealing', and was neither explicable as being for family succession or for commercial purposes. Further, the Court considered the arrangements in the context of the historical behaviour of the parties, concluding that it was inconsistent with that behaviour and that no sensible commercial or family rationale had been established for adopting the buy-back procedure.”¹⁴*

4.7 TR 2022/4 also acknowledges that cultural factors may inform the question on whether a dealing is an ‘ordinary family dealing’ distinguishing family dynamics where it is cultural for ‘grandparents [to gift]...money or goods to younger members of the family’¹⁵ to those where a beneficiary ‘for religious reasons will not accept the entitlement’.¹⁶ Consideration may also be held whether cultural practices of a family group extends to circumstances where it is expected that ‘children will meet the needs for shelter and living of their parents and other older relatives when they are no longer participating in the workforce’.¹⁷

4.8 Ultimately, what constitutes an ‘ordinary family dealing’ requires an understanding of a family group’s circumstances and arrangements for one client may not necessarily be suitable for another.

4.9 Example 8 of TR 2022/4 notes how the inclusion of any of the following factors may impact the ordinary family dealing of parents making a trust distribution to an adult child to assist with the purchase of a home:

- (a) *“If the arrangements were to involve parents gifting money received from a trust to their children repeatedly and one or more of the following factors are present*
- (i) *the parents have a lower marginal tax rate*
 - (ii) *the parents have lesser financial means than the adult child, or*
 - (iii) *the adult child is also capable of benefitting under that trust in their own right; for example, the parents may be subject to lower tax rates because they are retired and in pension phase or have significant losses to reduce tax payable on trust distributions.*
- (b) *Arrangements where the situation is reversed, so that Alex (who has limited financial resources apart from a distribution made to her and has a lower marginal tax rate) gifts money to her parents Lisa and Jessie who are subject to higher rates of tax, and there is no financial or cultural circumstance that would explain the gift.*
- (c) *Arrangements where Alex, who has a lower marginal tax rate, agrees to apply her trust entitlements to reimburse her parents for costs incurred by them on her maintenance, education and financial support while Alex was a minor.”*

¹⁴ TR 2022/4 at paragraph 98

¹⁵ TR 2022/4 at paragraph 110

¹⁶ TR 2022/4 at paragraph 113.

¹⁷ TR 2022/4 at paragraph 111.



- 4.10 Given the prevalence of trusts as a business and investment vehicle, it is acknowledged that undertaking the above analysis for each family group may not be possible.
- 4.11 Accordingly, PCG 2022/2 provides 'Green zone' scenarios in which the ATO will not dedicate compliance resources given the low risk nature of such examples.
- 4.12 It should be noted that PCG 2022/2 does not state the law, but rather outlines scenarios that are more likely to be criticised than others.
- 4.13 In relation to a company beneficiary, Scenario 3B of PCG 2022/2 notes that distributions to a company beneficiary may fall within the green zone where:
- (a) there is a retention of funds;
 - (b) the company is not an exempt entity;
 - (c) the company is a member of the same family group (see paragraph 25(f) for the meaning of family group);
 - (d) the retained funds are used for the working capital of a business that the trust actively carries on; or are used to acquire, maintain or improve investment assets of the trust (as well as other circumstances – see paragraph 25(c) for additional circumstances and paragraph 25(d) for situations when this condition will not be met);
 - (e) a complying Division 7A loan agreement is entered into (note TD 2022/2 discussed above);
 - (f) none of the following exclusions apply:¹⁸
 - (i) *the arrangement is a red-zone arrangement (see paragraphs 34 to 48 of PCG 2022/2)*
 - (ii) *the beneficiary makes a gift of the funds received either in satisfaction of their trust entitlement or from an associated amount (an example of an associated amount includes where the unpaid present entitlement (UPE) was converted into a loan) except where the gift meets the requirement of Green zone: scenario 1*
 - (iii) *the beneficiary disclaims their entitlement or forgives or releases the trustee from its obligation to pay their trust entitlement or an associated amount receivable from the trust (an example of an associated amount is where the UPE was converted into a loan)*
 - (iv) *the beneficiary's entitlement is less than the beneficiary's share of net income, franked dividends of the trust and trust capital gains as a result of the trustee exercising a power, or the deed being amended or varied, to affect the quantum of income of the trust estate*
 - (v) *a beneficiary's trust entitlement is satisfied by payments that are sourced from that beneficiary, or a beneficiary's trust entitlement has been made subject to a loan agreement and the repayments of that loan are sourced from payments or loans from that beneficiary; examples include where a trustee*

¹⁸ PCG 2022/2 at paragraph 32.



- (A) *satisfies a corporate beneficiary's UPE or makes a loan repayment to that corporate beneficiary by way of set-off against a dividend paid by that corporate beneficiary*
 - (B) *issues units in the trust to the beneficiary and the amount owed for the units is set-off against the amount payable by the trust to the beneficiary, or*
 - (C) *satisfies a beneficiary's entitlement or satisfies a loan repayment to that corporate beneficiary by way of set-off against that trustee's entitlement to income of another trust that includes franked distributions paid by that corporate beneficiary*
 - (vi) *the beneficiary is a loss company or loss trust that uses its trust entitlement to fund a distribution to its members and that distribution compromises the ability of the beneficiary to repay its existing or future liabilities*
 - (vii) *the beneficiary is a private company that uses its trust entitlement to fund a distribution that is made directly or indirectly to a non-resident*
 - (viii) *the beneficiary is a private company or trust that uses its trust entitlement to fund a distribution that is made directly or indirectly to the trustee that made the beneficiary presently entitled to income*
 - (ix) *the trustee has not notified the beneficiary of their entitlement to trust income by the earlier of the trustee's due date and actual date of lodgment*
 - (x) *where the beneficiary that is presently entitled to trust income in a year is required to lodge a tax return for that year, either the*
 - (A) *beneficiary has not lodged, or*
 - (B) *the beneficiary has understated or omitted in that tax return their share of the trust net income, trust capital gains or franked dividends received from the trust*
 - (xi) *the beneficiary uses the trust entitlement to pay excessive consideration where the parties are not dealing at arm's length.*
- 4.14 Accordingly, where distributions are made to a company beneficiary, written evidence should be retained to confirm the applicability of Scenario 3B. Such evidence can include:
- (a) The entering into a complying Division 7A loan agreement.
 - (b) Evidencing the use of such retained funds in the working capital for the trust (whether noting by way of resolution, notes or records of discussions or meetings).
 - (c) Ensuring appropriate accounting records are retained.
 - (d) Evidencing any future dividend declared are sourced separate from the trust distribution.
- 4.15 In determining whether to make trust distributions to adult child, care must be taken in light of:
- (a) Red Zone scenario 1 of PCG 2022/2 – which involves an adult beneficiary in receipt of a trust distribution making gifts or loans to another party where such:



- (i) distribution is paid to the parent or caregiver of the beneficiary in connection with expenses incurred before the beneficiary turned 18 years of age;
 - (ii) distribution is applied by the trustee of the trust against a debit balance account for the beneficiary representing expenses incurred by the trustee in respect of the beneficiary before they turned 18 years of age; or
 - (iii) adult beneficiary is a non-resident relative of the resident controller of the trust and the distribution is made available to a resident taxpayer by way of loan or gift.
- (b) TA 2022/1 – which outlines the scenarios in which the ATO will consider parents as benefiting from trust distributions made to adult children. Such arrangements cause concern given the ability to access tax-free thresholds or lower marginal tax rates of such adult children.¹⁹
- 4.16 TA 2022/1 provides the following two examples of trust distributions to adult children failing to fall within the meaning of ordinary family dealing.

Example 1

7. *The ABC Trust's beneficiaries include the members of the ABC Family. David is the sole trustee of the ABC Trust. David and his wife Rani have two children, Jenny (aged 22) and Paul (aged 19), who live with them in the family home. David and Rani have an existing mortgage on the home. Jenny and Paul are both full-time students and during the 2020–21 income year, they each earned approximately \$12,000 from casual employment.*

8. *During the 2020–21 income year, the ABC Trust derives income of \$720,000 (the trust's net income is also \$720,000).*

9. *A resolution of the trustee of the ABC Trust dated 30 June 2021 shows both Jenny and Paul are each presently entitled to \$160,000 of the income of the ABC Trust, with David and Rani each presently entitled to \$200,000.*

10. *Jenny and Paul are not paid any amounts. Instead, David transfers an amount equal to their entitlements to the mortgage offset account that he and Rani maintain. Jenny and Paul's entitlements are recorded as having been fully paid in the accounts of the ABC Trust. David pays Jenny and Paul's tax liabilities in relation to their entitlements from his personal funds.*

11. *David has taken these actions as Jenny and Paul have agreed that their entitlements from the ABC Trust will be managed by David for the benefit of all family members. David has determined that those entitlements should be applied to reduce the debt on the family home.*

12. *This arrangement raises the concerns mentioned in this Alert. By entering into this arrangement, the purported \$160,000 entitlements of both Jenny and Paul are not subject to the top marginal tax rate. David has not managed the entitlements for the benefit of all members of the family. The arrangement has the result that the post-tax amounts of Jenny and Paul's entitlements have been diverted to meet their parent's individual liabilities in circumstances where their parents would have been able to meet them. David and Rani receive the same economic benefit from that income as if it had been appointed to them directly, but without the amounts being included in their assessable income and subject to tax at a higher marginal tax rate. The arrangement involving the making of the trust*

¹⁹ TA 2022/1 at paragraph 3.



distributions and use of those amounts appears to be motivated by the tax outcome achieved rather than ordinary familial objectives.

Example 2

13. *The trustee of the Blue Family Trust is Azure Pty Ltd. Trevor is the sole shareholder and controller of Azure Pty Ltd. The Blue Family Trust derives assessable income in excess of \$400,000 a year. Trevor's daughter, Simone, is a beneficiary of the trust. Simone has recently turned 18 years of age and works part-time. Simone expects to derive assessable income from her work of approximately \$20,000 a year.*

14. *Before the end of the 2020–21 income year, Simone meets with her father and agrees that any distribution resolved to be made by the Trustee will, after the payment of tax, be paid to Trevor to reimburse him for part of the fees for secondary schooling and costs of other extracurricular activities since Simone was five years old. Records maintained by the family show that these expenses amounted to \$315,000.*

15. *The Trustee resolves to distribute \$160,000 to Simone and pays this amount into an account held in Trevor's name. Trevor pays income tax on Simone's behalf.*

16. *This arrangement raises the concerns that are mentioned in this Alert. Simone is purportedly made entitled to a trust distribution and this amount is used to reimburse her parents for expenses that they would ordinarily meet. The arrangement, which results in Trevor obtaining the economic benefit of the trust income without that income being subject to tax at the top marginal tax rate he would otherwise have paid, appears to be more readily explained by the tax outcomes achieved, rather than any familial objectives.*

4.17 In contrast, Example 3 TA 2022/1 differs from Example 2 above by noting that the expenses in which the child repays would be considered legitimate expenses that an adult child may incur (e.g. university tuition fees and arm's length board):

"17. The Green Trust's beneficiaries include the members of the Green Family. Mary Green is the sole trustee of the Green Trust. Mary has an adult child, Genevieve (aged 19), who lives with her grandmother in order to be close to the university she attends.

18. *It is agreed between Mary and Genevieve that Genevieve's tuition fees of \$20,000 will not have to be met by Genevieve but that they will be paid out of her trust entitlement. It is agreed between Genevieve and her grandmother that the grandmother will be paid board of \$10,000 a year.*

19. *During the 2020–21 income year, the Green Trust derives income of \$300,000 (the trust's net income is also \$300,000).*

20. *On 30 June 2021, Mary as the trustee of the Green Trust resolves to make Genevieve presently entitled to \$40,000 of the trust income and make Mary entitled to the remaining \$260,000.*

21. *\$20,000 of the \$40,000 that Genevieve is presently entitled to is paid to Mary, who has previously met the tuition fees of \$20,000 as they fell due. \$10,000 of that \$40,000 is paid directly to the grandmother. The remaining \$10,000 is paid to Genevieve, some of which is used to meet her tax obligations on the \$40,000.*

22. *Although \$30,000 of the \$40,000 is not received directly by Genevieve, and might appear to be within the scope of this Alert, it is important that the \$30,000 is applied to repay loans for legitimate expenses that might ordinarily be borne by an adult child and were temporarily met on Genevieve's behalf (being tuition fees and arm's length board). The remaining*



\$10,000 was actually received by Genevieve. Accordingly, the concerns raised in this Alert do not arise in arrangements of this type.”

- 4.18 An important distinction between Examples 2 and 3 of TA 2022/1 is whether the ‘reimbursement’ to the parent from the child (using the trust distribution funds) is in relation to expenses incurred by the parent whilst the child was a minor or over 18. Where the reimbursement relates to expenses incurred whilst the child was a minor, such reimbursements would fall within Red Zone scenario 1 of PCG 2022/2.
- 4.19 Other than considering the above ATO guidance, steps should be taken to ensure the proper administration of the trust.
- 4.20 This may include the following:
- (a) Appropriate steps to ensure trust resolutions are prepared pursuant and in compliance with the terms of the trust deed.
 - (b) Ensuring each beneficiary recipient is advised of their entitlements in writing.
 - (c) Ensuring the accounts of the trust properly reflect the treatment of such entitlement.
 - (d) Where a beneficiary wishes to apply their entitlement in a certain manner (whether by way of gift or loan), steps should be taken that appropriate written documentation are drawn and executed to confirm how such entitlement is to be dealt with.
 - (i) In considering this step, thought should be had to ATO commentary at the time.
 - (ii) This may include ensuring proper evidence and records are retained as to any expenses incurred by an adult child but paid for by another family member.
 - (iii) Where there are dealings amongst related family members, thought should be had whether such dealings may also be considered arm’s length.
- 4.21 Importantly, trustees of a trust should not be seen as influencing beneficiaries in making such decisions relating to their entitlement prior to any trust distribution. This may mean that beneficiaries are informed of their ability to seek payment of their entitlement in cash, if they so choose.



6 Trust distributions and family trust distribution tax

- 6.1 Family Trust Distribution Tax may arise where **family trust elections** have been made and distributions of that **family trust** are made to persons who fall outside the **family group**.
- 6.2 Before considering what constitutes a family group and noting when distributions may be made outside the family group, it should be appreciated why a discretionary trust may make a family trust election.
- 6.3 Specifically, a family trust election may be made to assist with any of the following:
- (a) Enabling a discretionary trust to utilise trust losses (discussed in this section given the relevance of trust losses in considering the making of trust distributions).
 - (b) Assisting a company with a discretionary trust shareholder to satisfy the company loss provisions.
 - (c) Enabling a discretionary trust to satisfy the holding period rule for franking credits.
 - (d) Meeting the ultimate economic ownership rules of the small business restructure rollover of Subdivision 328-G.
- 6.4 Schedule 2F of ITAA 1936 contains the relevant legislation regarding the ability to utilise trust losses.
- 6.5 Due to the difficulty of a discretionary trust to utilise existing tax losses via a distribution from another discretionary trust, it is recommended a family trust election be made in favour of the Trust.
- 6.6 This is because ordinarily a standard discretionary trust would be considered a 'non-fixed trust' for the purposes of the trust loss provisions. In being a non-fixed trust, four tests are required to be met for that discretionary trust to potentially utilise trust losses.
- 6.7 These four tests are the:
- (a) Pattern of distributions test – which requires an analysis of a trust's distribution year-on-year to ensure the loss may be carried forward (and historical trust distributions may impact the ability to meet this test in the event a family trust election is sought in the future).
 - (b) Control test – which requires an analysis of the persons who may control the trust from the year in which the loss was incurred and the year in which the loss will be utilised.
 - (c) 50% stake test – which requires individuals with a 50% stake in the relevant trust to remain, which is difficult in relation to non-fixed trusts.
 - (d) Income injection test – Which is failed if an 'outsider' provides a benefit to the trust. Where no family trust election is made in relation to the trust, an 'outsider' is a person other than the trustee of the trust or a person with fixed entitlements to a share of the income or capital of the trust, meaning the only way to meet this test without a family trust election is if the trust itself generates income (i.e. the trust cannot receive income from external sources to offset against the loss).
- 6.8 It is difficult to ordinarily meet all four tests (or the compliance burden may be uncommercial), and is impossible to meet the income injection test for the trust if the trust receives a trust distribution from another discretionary trust.
- 6.9 In contrast, if a discretionary trust makes a family trust election, it is only required to satisfy the income injection test (modified to limit who is considered an outsider) in order to utilise



trust losses. The disadvantage in making the election is the reduction of the class of beneficiaries of the trust to those within a 'family group' and the application of a Family Trust Distribution Tax where distributions are made outside this 'family group'.

Making a family trust election

- 6.10 Subdivision 272-D ITAA 1936 outlines the circumstances in which a family trust election can be made over a trust.
- 6.11 Specifically, section 272-80 ITAA 1936 provides for the following:
- (a) A trustee of a trust may make a family trust election in a specified income year.
 - (b) The election must be made in writing and in the approved form.
 - (c) The election must specify an individual whose family group is to be taken into account regarding the election (**selecting a Test Individual**).
 - (d) The trust must pass the family control test (**Family Control Test**). A trust passes this test if a Test Individual and/or members of the family (collectively, the **group**), control the trust from the specified year in which the family trust election starts (**Commencement Year**) until the income year before the election year is made (**Current Year**).
 - (e) The specified income year may be made before the year in which the election is made if:
 - (i) at all times from the beginning of the specified income year until 30 June of the income year in which the election was made – the trust passes the Family Control Test; and
 - (ii) any conferrals of present entitlement or distributions made during the above period was only made to the Test Individual and members of the Test Individual's family (**Family Distribution Test**). That is, all distributions from the trust from the Commencement Year to the Current Year must have been made to the Test Individual or their family group.
- 6.12 The remaining provisions of section 272-80 ITAA 1936 relate to the revoking and varying of the family trust election and are not relevant for the purposes of making a family trust election.

Selecting a Test Individual

- 6.13 Selecting a Test Individual is crucial in satisfying the relevant tests and acknowledging who are entitled to receive distributions from the trust which a family trust election has been made.
- 6.14 Once a family trust election has been made, a Test Individual and their **family group** may receive distributions from the trust without adverse tax implications. Distributing outside the family group after a family trust election has been made results in a Family Trust Distribution Tax being levied on the distribution.
- 6.15 Care needs to be taken a 'distributes' takes on a broader meaning (pursuant to sections 272-45 to 272-60 Schedule 2F ITAA 136) which can include (but is not limited to):
- (a) Paying (including by way of a loan) or credits money to a person or reinvests much for a person.
 - (b) Transferring property to an entity or allowing the use of property of the entity to a person.



- (c) Extinguishing, forgiving, releasing or waiving a debt or other liability owed by a person.
- (d) The buy-back of share capital.

6.16 A **family group** includes (per section 272-90 ITAA 1936):

- (a) A family member of the Test Individual (as provided for in section 272-95 ITAA 1936) which includes:
 - (i) any parent, grandparent, brother or sister of the Test Individual or the Test Individual's spouse;
 - (ii) any nephew, niece or child of the Test Individual or the Test Individual's spouse;
 - (iii) any lineal descendant of a nephew, niece or child referred to above;
 - (iv) the spouse of any of the persons referred to above.
- (b) Certain former family members.
- (c) The trust which made the family trust election.
- (d) Any trust which has made a family trust election with the same Test Individual.
- (e) Any entity which has made an interposed entity election.
- (f) Any entity in which the Test Individual or their family (or relevant entities) own the entity.
- (g) Certain tax exempt bodies.

6.17 Selecting an appropriate Test Individual will allow for the Trust to receive distributions from 'external trusts' as the Income Injection Test will be met.

6.18 Section 270-10 ITAA 1936 outlines the Income Injection Test.

6.19 At it's simplest, the test will be failed where an outsider of the trust provides a benefit to the trust as part of a scheme.

6.20 An 'outsider' to a family trust is defined in section 270-25(1) ITAA 1936 to be a person other than certain persons, including a trust with the **same Test Individual** specified in its family trust election; or a trust which has made an interposed entity election to be included in the Test Individual's family group.

Risk of Family Trust Distribution Tax

6.21 In light of the broadened definition of 'distributes', care must be taken with discretionary trusts who have made family trust elections to ensure that distributions with persons outside the 'family group' are performed at market value.

6.22 ATO ID 2004/162 considered whether Family Trust Distribution Tax applied to a redemption of units where the amount paid exceeded the value of any consideration given in return. The ATO determined that Family Trust Distribution Tax would apply to the extent that the payment made in respect of the redemption exceeded the value of any consideration given in return.

6.23 Other examples of distributions that may result in Family Trust Distribution Tax include:

- (a) The transfer of shares by a family trust for less than market value to another family trust that is not within the family group – see section 272-60(1) Schedule 2F ITAA 1936.



- (b) Dividends declared by a company (which has made an interposed entity election linked to Person A) to a newly introduced shareholder family trust (which has made a family trust election in favour of Person B) which does not fall within the family group of Person A – section 272-50 Schedule 2F ITAA 1936.
 - (c) The transfer of business assets out of a company (which has made an interposed entity election linked to Person A) to an entity controlled by Person B (and which Person A has no involvement with) – section 272-60 Schedule 2F ITAA 1936.
- 6.24 A key theme of managing the above risks is to take care when dealing with a company that may have made an interposed entity election. When acting on behalf of a purchasing entity, appropriate due diligence must be undertaken.
- 6.25 Other than consideration of the broadened definition of 'distributes', care should be had when making a trust distribution from a discretionary trust that has made a family trust election. Prior to such distribution resolution being executed, steps should be taken to confirm any recipient beneficiary falls within the definition of family group, as well as within the general class of beneficiaries in the trust deed.



7 Trust distributions and “real and genuine” consideration

7.1 It is well established that discretionary beneficiaries of a discretionary trust:

- (a) only have a ‘mere expectancy’ to receive any of the trust fund and cannot force a trustee to distribute trust funds in their favour²⁰ (subject to the rule of equity in *Saunders v Vautier*²¹); and
- (b) can only compel the trustee to properly administer the trust.²² Specifically:

‘[N]o object of a discretionary trust has, as such, any legal right to or in the capital. His sole interest, if it be an “interest” within the scope of these provisions is with regard to the income: he can require the trustees to exercise, in bona fide, their discretion as to how it shall be distributed, and he can take and enjoy whatever part of the income the trustee choose to give him. I cannot see any ground for holding that he can have any “interest” in the capital if he has no interest in the income.’²³

7.2 Even though the above common law statements arose from English cases, Australian law has adopted the conclusions:

- (a) Per Owen J in *R and I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* [1992] 10 WAR 59 at 79:

The trustee has a duty to administer the trust bona fide having regard to the purpose for which it was established. This is a duty which the court will enforce at the behest of the beneficiary. In this way, the remedy defines the nature of the interest of an individual beneficiary.

- (b) Per French J in *Richstar Enterprises Pty Ltd and Others; Australian Securities and Investments Commission v Carey (No 6)* (2006) 153 FCR 509 at 29:

... in my opinion, in the ordinary case the beneficiary of a discretionary trust, other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of “property”....

- (c) In *Kestenberg v Kestenberg* [2020] VSC 84 at 7:

[A] discretionary beneficiary has no proprietary interest, vested or contingent, in the assets of a trust but only an expectation...a discretionary beneficiary, is not entitled as of right to disclosure of that which could be properly described as ‘trust document’

7.3 The above cases reinforces the law that beneficiaries of a discretionary trust have no direct interest in the income and capital of the trust, and that the trustee (being the various companies) has the absolutely discretion to determine how such income and capital of the trust is to be distributed.

7.4 Notwithstanding the above case law, the case of *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 (**Owies**) confirmed that although beneficiaries cannot force distributions to be made in

²⁰ *Pearson v Inland Revenue Commissioner* (1981) AC 753

²¹ The rule in *Saunders v Vautier* (1841) EWHC Ch J82 states that all beneficiaries of a trust can force the trustee to dissolve the trust and pay the trust fund. For a discretionary trust, this will need to include all Discretionary Beneficiaries including eligible trusts and companies

²² *Gartside v Inland Revenue Commissioners* (1986) AC 553

²³ *Gartside v Inland Revenue Commissioners* (1986) AC 553 at 606



their favour, trustees must exercise any discretion having applied 'real and genuine' consideration to the decision.

- 7.5 *Owies* involved estranged children challenging decisions made by a trustee of a discretionary trust (in which the estranged children were named as primary beneficiaries with their parents and brother).
- 7.6 The case is one of many considering whether a trustee's decision of a discretionary trust may be challenged.
- 7.7 Courts will generally not question the merits of a discretionary decision taken by a trustee as they seek to abide by a 'principle of non-interference'²⁴. This is due to Courts being reluctant to overturn the valid choice of persons to utilise such a discretionary structure – *[I]t is to discretionary of the trustees that execution of the trust is confided...* [However, the discretion must be exercised] *within an entire absence of indirect motive, with honesty of intention, and with fair consideration.*²⁵
- 7.8 However, where a trustee has failed to exercise their discretion 'in good faith' Courts may consider the appropriateness of such decisions.
- 7.9 A lack of good faith can exist where a trustee:
- (a) fails to consider the intention of the trust's creator/settlor prior to making a decision;
 - (b) is deliberately deceptive for their personal gain or decisions are exercised with dishonesty; or
 - (c) fails to give real and genuine consideration to the exercise of their discretions.
- 7.10 Consideration will be had to some cases exploring what constitutes 'real and genuine consideration' before appreciating the facts of *Owies*.

Hoh v Ying Mui Pty Ltd²⁶

- 7.11 This case related to a bitter family dispute between two factions of the Hoh family:
- (a) the George faction – based in Malaysia; and
 - (b) the Frank faction – based in Australia.
- 7.12 The dispute related to the actions of the Frank faction regarding multiple discretionary trusts (the Ying Mui Trust, The Amore Trust and FRG Investments Trust, collectively the **Trusts**) owning significant Australian assets (accumulated by Hoh Senior during his lifetime), whereby the Frank faction greatly benefited.
- 7.13 Such actions included:
- (a) selling assets held by the Ying Mui Trust to associated persons of the Frank faction;²⁷
 - (b) deliberately misleading the George faction as to the assets and distribution holding of the trust;²⁸

²⁴ See G Thomas, *Thomas on Power* (1st edn), Sweet & Maxwell, London, 1998, at [6-204]

²⁵ *Re Beloved Wilkes Charity* (1851) 3 Mac & G 440; 45 ER 330 at 333

²⁶ [2019] VSCA 203

²⁷ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 41

²⁸ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 42



- (c) arranging for net income of the Ying Mui Trust to be distributed to associated persons of the Frank faction; and²⁹
 - (d) entering into management fee agreements in favour of associated persons of the Frank faction.³⁰
- 7.14 Such was the degree of abuse of power, the trial Courts ordered:³¹
- (a) a new trustee be appointed to each of the trusts and the trust assets be transferred to the new trustee;
 - (b) associated persons of the Frank faction pay equitable compensation to the new trustee in respect of management fees and trust distributions made; and
 - (c) the sales of properties from Ying Mui Trust be set aside and the properties retransferred to the Ying Mui Trust.
- 7.15 Much of the decision was made on the basis that the Frank faction breached their fiduciary or statutory duties for the Trusts by entering into management fee arrangements and making trust distribution payments; and such determinations were questioned on appeal.
- 7.16 For the purposes of this paper, the following was noted by the Court in determining that duties were breached by the Frank faction.
- 7.17 The Court held that the Frank faction were in a position of clear conflict of interest in addition to utilising their position as director of various corporate trustees to benefit their associated entities to the detriment of the corporate trustees, by entering into management fee agreements.³²
- 7.18 Regarding the receipt of trust distributions as breaches of trust, it was noted that:
- (a) distributions should have been taken as having been motivated by the Frank faction's *'improper purpose of obtaining a 'fighting fund' to be used by the Frank faction against the George faction in anticipated litigation concerning the administration and control of the Ying Mui trust'*;³³
 - (b) members of the Frank faction *'did not give any genuine consideration to how the discretion of appointment ought to have been exercised, or whether the 2012–2014 Distribution Payments were in the best interests of the present and future beneficiaries of the Ying Mui Trust and the Amore Trust'*.³⁴
- 7.19 In addition, the trial judge (with the Court of Appeal) held that:³⁵
- (a) any argument that the distributions were for the benevolent purpose of protecting the Trust funds from the George faction could not be relied upon as no such purpose existed on construction of the trust deeds;
 - (b) in exercising the trustee discretion to distribute, members of the Frank faction exercised their powers in bad faith and in a dishonest faction by concealing actions

²⁹ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 51

³⁰ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 41

³¹ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 55

³² *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 265

³³ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 280

³⁴ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 281

³⁵ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 282



from the George faction, as well as for an improper purpose of establishing a fighting fund.

- 7.20 Certainly the existence of letters from the Frank faction to the George faction of the following effect, would cause concern as to the ability for those in the Frank faction making decisions relating to the Trusts to make such decisions with proper consideration as required under trust law:

By letter dated 31 July 2010, she rejected the proposed meeting and stated that the dispute was 'past the point of discussion' because: 'MY DAD HAS MADE HIS DECISION — in his words, he wants "out" of all business associations with the extended Hoh family'.

Lynn said in her letter that her proposal: 'was a "cleaner" solution to my dad's initial intentions to effectively wind up all these businesses with a view to distributing the proceeds to relevant parties', [24] and continued: '[t]he only decision that needs to be made here is by you and uncle George — whether you want to accept my proposal as set out in my letter, or take your chances with what my dad will do if you reject my proposal'. [25] She set a deadline of 6 August 2010 for acceptance of her proposal and, on Frank's instructions, threatened that he would 'do it his way' if the proposal was not accepted by that time.³⁶

- 7.21 Further, the Court noted that "George's statements are consistent with him working for the whole family (including Derek and Richard) on behalf of SYM and with Frank acting for the narrower family (excluding Derek and Richard) on behalf of Ying Mui".³⁷

Callus v KB Investments³⁸

- 7.22 In contrast to the *Ying Mui* case, the Victorian case of *Callus v KB Investments* [2020] VCC 135 is example where by a disgruntled beneficiary could not establish the fact that the trustee 'was not in a position to give real and genuine consideration to the interests of the beneficiaries, or that it did not give real and genuine consideration of those interests'.
- 7.23 This was notwithstanding that the trustee of the trust in that case transferred a property to one of the beneficiaries over another and left no written reasons or record for making such a decision.
- 7.24 In that case, a disgruntled family member challenged the trustee's discretion to transfer trust property to one of four named beneficiaries in a discretionary trust deed.
- 7.25 The Court undertook to consider, not whether the final outcome was fair, but rather whether the trustee at the time had proper consideration as part of the process of making a decision.

What is 'real and genuine consideration'

- 7.26 The case provides a detailed summary of the relevant legal principles by referencing McMillan J in *Re Marsella; Marsella v Wareham (No. 2)* [2019] VSC 65.³⁹
- 7.27 The key principles can be summarised as follows:
- (a) In accepting to be a trustee, the trustee is bound by duties to exercise their power in the best interest of beneficiaries.

³⁶ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 38

³⁷ *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 140

³⁸ *Callus v KB Investments* [2020] VCC 135

³⁹ *Callus v KB Investments* [2020] VCC 135 at [141]



- (b) Where a trustee is provided 'unfettered discretion', such discretion must be exercised in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred.
- (c) In determining whether such discretion was exercised appropriately, a Court may look at the inquiries the trustee made, the information they had, and their reasons for, and manner of, exercising their discretion.
- (d) It is not the Court's role to determine the weight of such matters in the trustee exercising its discretion.
- (e) A lack of good faith can include the taking account of irrelevant considerations and a refusal to take into account relevant considerations.
- (f) The trustee must inform themselves of the relevant matters to exercise the discretion. Where the consideration is not properly informed, then it is not genuine.
- (g) Finally, the purpose for which a power is conferred on the trustee must be inferred from the trust deed.
- (h) Whether a trustee exercised a power for a proper purpose is a question of fact to be decided on the evidence. A trustee is not bound to disclose her or his reasons in reaching a particular decision, and a negative inference cannot be drawn from the non-disclosure by a trustee of the reasons for his or her decision.

7.28 In this case, the Court held that there was no proof that the trustee did not act honestly and in good faith. The Court considered the following:

- (a) the trustee exercised their discretion pursuant to the terms of the discretionary trust (including not being required to retain records of the decision or not being required to seek the guidance of the Guardians);⁴⁰
- (b) the trustee exercised their discretion per an oral recollection from the prior decision-maker of the trust (being the father of those managing the trustee);⁴¹
- (c) there was no hostility between the trustee and disgruntled beneficiary at the time of the transfer (such hostility arising at a later point in time);⁴² and
- (d) there was sufficient evidence that on the balance of probabilities, the trustee obtained appropriate legal advice regarding the deed prior to exercising its discretion.⁴³

Owies

7.29 The case revolved around the administration of a discretionary family trust established by John and Eva Owies in 1970.

7.30 The trust was structured with JEE Nominees Pty Ltd acting as trustee and John and Eva's children: Michael, Paul, and Deborah, as primary beneficiaries. John and Eva were also included as general beneficiaries.

⁴⁰ Callus v KB Investments [2020] VCC 135 at [145] and [148]

⁴¹ Callus v KB Investments [2020] VCC 135 at [149] and [150]

⁴² Callus v KB Investments [2020] VCC 135 at [152]

⁴³ Callus v KB Investments [2020] VCC 135 at [153]



- 7.31 Whilst the trustee had broad discretionary powers to distribute the trust's income, the terms of the trust were drafted such that any 'default income' would be held by the trustee on trust for each of Michael, Paul and Deborah equally.
- 7.32 Much of the dispute related to various trust distributions made from 2011 to 2019 on the basis that:
- (a) From 2011 to 2018, the trustee allocated 40% of the trust's income to John, 40% to Michael, and 20% to Eva.
 - (b) In 2019, the trustee decided to distribute 100% of the income to John.
- 7.33 Accordingly, Paul and Deborah, challenged the trustee's decisions, arguing that the trustee failed to give "real and genuine consideration" to their interests, thus breaching its fiduciary duty.
- 7.34 The Victorian Supreme Court of Appeal found that the trustee had indeed breached its fiduciary duty by not properly considering whether distributions should be made to Paul and Deborah during the financial years ending 30 June 2017 and 2019. The court noted that the trustee's actions were influenced by strained family relationships and a lack of impartiality and a lack of impartiality. Consequently, the distributions made to John, Eva, and Michael were deemed voidable (albeit no order was sought to have the distributions set aside), and the Court ordered the removal of the trustee.
- 7.35 It is noted that both Paul and Deborah were both estranged from their parents at various points during the above period (whilst reconciling for periods as well) and Deborah in particular had medical conditions that affected her ability to work full-time for extended periods. In addition, Paul made enquiries relating to the trust to no avail.
- 7.36 In coming to their determination, the Court noted the following.
- (a) *'In considering the nature of the power to distribute annual income, the starting point must be the nature and purpose of the trust having regard to the terms of the trust deed. **The trust deed is by settlement, and as the preamble records, the settlor settled the sum 'being desirous of making provision for the Primary Beneficiaries and the General Beneficiaries'***⁴⁴.
 - (b) *'Given its terms, it would have been expected that the class of general beneficiaries would not be particularly large and would continue to revolve around the three Owies children. An obvious, but unstated, premise on which the trustee would be expected to discharge its duties is that it would generally be informed about the differing circumstances, needs and desires of each beneficiary as an incident of the familial bonds that underpin the trust and explain its purpose.'*⁴⁵
 - (c) *'The power in cl 3 to distribute annual income to the general beneficiaries is cast in the broad terms of 'an absolute discretion', a matter confirmed by the general provision of cl 17 that makes it plain that the trustee's powers are 'absolute and uncontrolled'. **Nevertheless, even such broadly expressed powers must be exercised in good faith and taking into account the purpose of the trust***⁴⁶
 - (d) *'In looking at the nature and purpose of the power to distribute income, it is also relevant that the trust deed provides, in default of appointment of income, and assuming they are living, that the three children hold the income pursuant to an*

⁴⁴ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [110]

⁴⁵ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [111]

⁴⁶ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [112]



*express trust in equal shares. The intention that the primary beneficiaries take any non-applied or accumulated income in the same manner as will occur with respect to the whole fund on vesting, reinforces the general default structure of the trust deed as one providing for the benefit of the children in equal shares.*⁴⁷

- 7.37 In addition to the decision, appreciation should be had from the trust deed of the case to more modern deeds:
- (a) *'In the case of some trusts, the number of potential objects might be very large and a requirement to undertake a detailed analysis of the identity and needs of each would be unworkable. Having considered whether or not to exercise the power and understood the range of objects that might benefit, the trustee is required to give adequate consideration as to how to exercise the power.'*⁴⁸
 - (b) The fact that the children were listed as 'Primary Beneficiaries' and entitled to take the income or capital on default of any determination played a part in determining whether appropriate consideration were made to them.

Information that may provide trustee with 'real and genuine' consideration

- 7.38 Case law exists which has accepted that a trustee may take into account a 'memorandum of wishes' in relation to a trust controlled by the deceased with the Courts accepting that the *'Trustee is entitled to take into account this memorandum of wishes in exercising its discretions conferred under the Trust Deed, just as the Trustee is entitled to take into account the views of beneficiaries'*.⁴⁹
- 7.39 The Court noted, referencing *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405, that the trustee is entitled to take into account the memorandum of wishes in determining how to deal with the assets of a discretionary trust:
- "[62] But as Campbell JA said speaking extra-judicially, established principles of trust law would appear not to require the application of rules of natural justice to the decisions of discretionary trustees: see JC Campbell "Exercise by Superannuation Trustees of Discretionary Powers" [2009] 83 ALJ 159, at 175. As Campbell JA said, the private law context in which trustees make their decisions usually does not give rise to an obligation to adhere to the rules of natural justice but this is really as a matter of construction of the constitutive documents of the trust. But his Honour also pointed out that the well-known obligation of trustees to give "genuine consideration" to the exercise of a discretion will sometimes mean the trustee will be required to gather information the trustee does not then hold and that such a procedure, though not identical to affording rights of natural justice or procedural fairness, covers at least some of the same ground. But Campbell JA also observed in the common case of a family discretionary trust the trustee will frequently already know enough about the circumstances in life of the various potential objects of the power of appointment to be able to make an appointment without gathering extra information."*⁵⁰
- 7.40 In this regard, the Court reiterated that "the Trustee's obligations in this area are well established: *Karger v Paul* [1984] VR 161 at 164, 166 and 178. It can be assumed that the Trustee will follow established law in respect of the degree of inquiries the Trustee has to

⁴⁷ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [113]

⁴⁸ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [95]

⁴⁹ *Monaghan v Monaghan* [2016] NSWSC 1316 at [49]

⁵⁰ *Monaghan v Monaghan* [2016] NSWSC 1316 at [62]



make in order to give “genuine consideration” to the exercise of its discretion to reach the decision that the Trustee contemplates”.⁵¹

- 7.41 Where such Trustee exercises their power bona fide and with no improper motives, then the Trustee will generally not be obliged to provide any reasons for their exercise of such discretionary powers.⁵² This will usually be there case where a Trustee seeks to administer the trust in the faithful performance of the settlor’s likely intentions of the terms of the particular trust in question (hence the need for successor Trustees to receive appropriate information regarding a trust creator’s intentions regarding the Trust).

⁵¹ *Monaghan v Monaghan* [2016] NSWSC 1316 at [63]

⁵² *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405 at 434



8 Trust distributions and small business CGT concessions

- 8.1 Where clients operate a business that may benefit from the small business CGT concessions, due care must be had in the years leading up to any potential sale.
- 8.2 Specifically, where the business is operated from a trust (or shares in a company are held by a trust that may declare dividends from the company), improper distributions may result in the inability to access the small business CGT concessions in future years (or the current year).

Trust distributions affecting small business CGT concession eligibility

- 8.3 A key requirement to accessing the small business CGT concessions is that a taxpayer either is a small business entity for the income year (**Turnover Test**) or satisfies the maximum net asset value test (**MNAV Test**).
- 8.4 In order to meet either test, the following must be satisfied:
- (a) Regarding the Turnover Test, one of the requirements to be met is that the entity's aggregated turnover for a year is less than \$2 million. 'Aggregated turnover' means the sum of the relevant annual turnovers of the following (per section 328-115 ITAA 1997):
 - (i) the entity's (taxpayer's) annual turnover for the income year;
 - (ii) the annual turnover for the income year of any entity that is connected with the taxpayer at any time during the income year; and
 - (iii) the annual turnover for the income year of any entity that is an affiliate of the taxpayer at any time during the income year.
 - (b) Regarding the MNAV Test, the sum of the following must not exceed \$6,000,000 (per section 152-15 ITAA 1997):
 - (i) the net value of the CGT assets of the entity (the taxpayer);
 - (ii) the net value of the CGT assets of any entities connected with the taxpayer; and
 - (iii) the net value of the CGT assets of any affiliates of the taxpayer or entities connected with the taxpayer's affiliates (not counting any assets already counted under paragraph (ii)).
- 8.5 A common link with both tests is this notion of an entity 'connected with' the taxpayer (in that the connected entity's turnover or net value of CGT assets are included in the test). The question, therefore, is how can a discretionary trust's distribution affect who is connected with a taxpayer.

Who can be connected with an entity

- 8.6 Under section 328-125 ITAA 1997, an entity is connected with another entity if:
- (a) Either entity is controlled by the other; or
 - (b) Each entity shares a common controller.
- 8.7 For these purposes, the meaning of control is specifically set out in the legislation and includes different tests for determining control of different types of entities.
- 8.8 Control for discretionary trusts are stated under section 328-125(3) ITAA 1997 as follows:



(3) An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its affiliates, or the first entity together with its affiliates.

(4) An entity (the first entity) controls a discretionary trust for an income year if, for any of the 4 income years before that year:

(a) the trustee of the trust paid to, or applied for the benefit of:

(i) the first entity; or

(ii) any of the first entity's affiliates; or

(iii) the first entity and any of its affiliates;

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

8.9 Importantly, a trust's distribution history may impact who is included in the calculation of a Turnover Test or MNAV Test in the future.

8.10 For example, an inadvertent distribution to an adult child or related family member who holds substantial assets (that fall within the definition of net value of CGT assets) or operates a business with a high turnover, may result in such assets or turnover being included in accessing whether an entity satisfies the Turnover Test or MNAV Test.

8.11 Alternatively, distributions to entities controlled by family members may cause unnecessary grouping.

8.12 Steps should therefore be taken to have appropriate tax planning discussions with clients prior to trust distributions being drawn, particularly, when business plans anticipate a likely sale in the near future for an entity.

Trust distributions impacting significant individual test

8.13 Where the small business CGT concessions are being sought in relation to the sale of shares in an entity operating a business(**object entity**), section 152-10(2)(d) ITAA 1997 requires either of the following to be satisfied just before the CGT event:

(a) the taxpayer is a CGT concession stakeholder in the object entity; or

(b) CGT concession stakeholders in the object entity together have a small business participation percentage in you (the taxpayer) of at least 90%.

8.14 Section 152-60 ITAA 1997 states that '[a]n individual is a **CGT concession stakeholder** of a company or trust at a time if the individual is:

(a) **a significant individual in the company or trust; or**

(b) **a spouse of a significant individual in the company or trust, if the spouse has a small business participation in the company or trust at that time that is greater than zero.'**



- 8.15 Section 152-55 ITAA 1997 states that '[a]n individual is a **significant individual** in a company or a trust at a time if, at that time, the individual has a **small business participation percentages** in the company or trust of at least 20%'.⁵³
- 8.16 Section 152-65 ITAA 1997 states that '[a]n entity's small business participation percentage in another entity at a time is the percentage that is the sum of:
- (a) the entity's **direct small business participation percentage** in the other entity at that time; **and**
 - (b) the entity's **indirect small business participation percentage** in the other entity at that time.
- 8.17 In determining an entity's direct small business participation percentage, section 152-70 ITAA 1997 notes in relation to a trust (where entities do not have entitlements to all the income and capital of the trust – e.g. a discretionary trust) – this percentage is:
- (a) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
 - (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled,
- or, if 2 different percentages are applicable, the smaller.**
- 8.18 Care should also be taken where the trustee of the trust fails to make a distribution of income **and** fails to make a distribution of capital.⁵³
- (a) if the trustee made a distribution of income or capital during the CGT event year, consider that year in determining the income or capital percentages; otherwise, consider the last income year before the CGT event year in which the trustee did make a distribution of income or capital;⁵⁴
 - (b) despite the above adjustment, an entity holds a direct small business participation percentage of 0% in the trust at the relevant time if either:
 - (i) the trust:
 - (A) had a net income for the relevant year; and
 - (B) did not have a tax loss for the relevant year; or
 - (ii) the trustee did not make a distribution of income or capital at any time before the end of the CGT event year.⁵⁵
- 8.19 In determining an entity's (the **holding entity**) indirect small business participation percentage in another entity (the **test entity**), section 152-75 ITAA 1997 requires the following to be multiplied:
- (a) the holding entity's direct small business percentage in an intermediate entity; and
 - (b) the sum of:
 - (i) the intermediate entity's direct small business percentage (if any) in the test entity at that time; and

⁵³ 152-70(4) ITAA 1997

⁵⁴ 152-70(5) ITAA 1997

⁵⁵ 152-70(6) ITAA 1997



- (ii) the intermediate entity's indirect small business participation percentage in the test entity at that time (as worked out under the above).

Where there is more than one intermediate entity, the calculation is applied at each level.

8.20 Whether the CGT concession stakeholder test is met will either depend on:

- (a) an individual holds a 20% small business participation percentage interest in the object entity (or the spouse of that individual holds an interest in the object entity of greater than 0%); or
- (b) an individual holding a 20% small business participation percentage interest or their spouse, and any other such persons holding a 90% interest in the taxpayer.

Discretionary trust issues in meeting 20% small business participation percentage

8.21 An overlooked issue may arise where there are discrepancies in the entitlements of the interest in the object entity.

8.22 For example, the small business participation percentage an entity has in a discretionary trust depends on:

- (a) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
- (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled,

or, if 2 different percentages are applicable, the smaller.

8.23 Where the trustee of the discretionary trust makes a distribution of income **and** capital in an year and the percentages differ, the smaller percentage applies.

8.24 This may be problematic in circumstances where persons A and B are made presently entitled to income, whilst person C is made presently entitled to the capital in an income year (as a result of seeking to stream capital gains to a person holding capital losses).

8.25 In such circumstances, no person will be determined to hold a direct small business percentage in the discretionary trust as persons A, B and C will have both been entitled to either income or capital or the trust, but neither of the other (and the direct small business participation percentage considers the smaller percentage):

<i>Beneficiary</i>	<i>Income %</i>	<i>Capital %</i>	<i>Direct small business participation percentage</i>
A	50%	0%	0%
B	50%	0%	0%
C	0%	100%	0%

8.26 Care must therefore be taken prior to the test point in time in ensuring appropriate trustee distribution minutes are prepared.

8.27 Further, where the terms of the trust deed cause a discrepancy in the definition of distributable income for the trust and capital, thought should be had as to the effect such distributions will be had to the relevant percentages.



- 8.28 ATO ID 2012/99 considers the meaning of the phrase 'distributions of income' and capital in the context of subsection 152-70(1) ITAA 1997 and states that '*references to distributions of income in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the deed and/or actions of the trustee, this may be an amount that differs from the ordinary income of the trust*'.
- 8.29 ATO ID 2012/99 notes that provided there is sufficient power in the trust deed, a trustee may validly resolve to treat capital gains as income of the trust and distribute such amounts accordingly.
- 8.30 Thought should also be had as to the effect TR 2012/D1 has in determining the income distributable by a trust and in turn the effect on determining an entity's small business participation percentage in the trust. Specifically, it should be noted that the **draft** ruling takes the view the income of the trust should not include notional amounts and therefore such notional amounts (such as franking credits and deemed capital gains) may not necessarily be income 'distributable' for the purposes of calculating the necessary percentages.
- 8.31 The interpretative decision acknowledges the decision in *Commissioner of Taxation v. Bamford* [2010] FCAFC 6; 2010 ATC 20-163 whereby the High Court determined that the term 'income of the trust estate' took its meaning according to appropriate accounting principles and the terms of the trust instrument.
- 8.32 ATO ID 2012/99 considered the following example:
- (a) Capital gain of \$90,000 made by a trustee of a discretionary trust in relation to the sale of shares in a company (the Object Entity).
 - (b) The trustee's interest in the company was 50%.
 - (c) In addition, the trustee derived ordinary income of \$10,000.
 - (d) The usual discretionary trust provisions applied as well as a power to determine whether receipts are on capital or revenue account.
 - (e) Pursuant to the relevant power, the trustee resolved to treat the \$90,000 capital gain as income of the trust and to distribute it to beneficiary A.
 - (f) Beneficiary B was distributed the \$10,000 ordinary income.
 - (g) In determining the small business participation percentage held by beneficiary A and B in the Object Entity, it was noted that:
 - (i) Beneficiary A held a 90% direct small business participation percentage in the discretionary trust (\$90,000/\$100,000 total income noting no capital distribution).
 - (ii) Beneficiary B held a 10% direct small business participation percentage in the discretionary trust (\$10,000/\$100,000 total income noting no capital distribution).
 - (iii) The discretionary trust held a 50% direct small business participation percentage in the Object Entity.
 - (iv) Beneficiary A therefore held a 45% indirect small business participation percentage in the Object Entity (90% * 50%).



- (v) Beneficiary B therefore held a 5% indirect small business participation percentage in the Object Entity (10% * 50%).
- (vi) Beneficiary A is therefore a CGT concession stakeholder in the Company as beneficiary A held a 45% small business participation percentage in the Company.
- (vii) Further, an individual holding a 20% small business participation percentage interest in the Object Entity has a small business participation percentage in the discretionary trust of 90%.
- (viii) It should be noted that if beneficiary B is a spouse of beneficiary A, they may also be considered a CGT concession stakeholder as they are a spouse of a significant individual (a person holding at least a 20% small business participation percentage interest in the Object Entity).
- (ix) The interpretative decision further notes that the above *'result would be different if the trustee had not resolved to treat the capital gain as income of the trust and had instead distributed the capital gain to beneficiary A as a capital distribution. The additional basic condition under paragraph 152-10(2)(b) would not be met because beneficiary A and B would each have a direct small business percentage in the trust worked out under item 3 of the table in subsection 152-70(1) of 0% (being the smaller percentage of the distributions of capital and income to which each beneficiary is beneficially entitled).'*

8.33 Where a trustee fails to make a distribution of income or capital, care must be taken as an entity will be considered to hold a direct small business participation percentage of 0% in the trust if the trust had net income in that income year and did not have a tax loss. Thought should be had as to whether any 'default income' provisions exist as the wording of such provisions may result in the trustee being deemed to have exercised a power to distribute such income to beneficiaries of the trust.

8.34 In light of the above, where discretionary trust are involved in the chain of entities in determining whether there is a CGT concession stakeholder, steps should be taken in advance to ensure the circumstances and appropriate distributions are made. Often revisiting a trustee's distribution minute after an income year in which a CGT event occurred, will be too late to determine and ensure appropriate considerations are made.



9 General trust distribution checklist

This checklist is not intended to be considered an exhaustive list but has been prepared to outline the various issues to consider prior to the preparation of a trust distribution resolution.

<i>Issue</i>	<i>What can go wrong?</i>
<i>The Who, What and When of Trust Distributions</i>	
Has the deed and all amending documents been validly executed/entered into?	Any identified defects should be rectified as soon as possible on the basis that difficulty may arise to rectify defects following identification by a Government body.
<p>Are the intended recipients beneficiaries of the trust?</p> <p>Are there any persons/groups of persons who are excluded as a beneficiary under the terms of the deed?</p>	<p>Confirm intended recipients are eligible to receive distributions from the trust.</p> <p>Common groups of persons who may be excluded as a beneficiary include, the Settlor and foreign persons.</p> <p>Less common groups of persons who may be excluded as a beneficiary include the trustee or former trustee; trusts or companies that the trustee or former trustee benefits from; persons on Centrelink benefits; the concept of a notional settlor.</p>
What 'income' can be distributed from the trust (E.g. what is distributable income)?	Confirm if income is according to ordinary principles, linked to section 95 income or if the trustee is able to determine the meaning of income.
Is there sufficient power to determine what distributable income is or categorise trust receipts/expenses on revenue or capital account?	If the defined meaning of Distributable Income in the trust is not preferred, identifying appropriate charactering powers is crucial in redefining the meaning of Distributable Income (within reasonable scope).
<p>Is there discretion to categorise and account income received as separate classes of income, specifically capital gains or franked distributions?</p> <p>Further, is there discretion to categorise and account expenses against separate classes of income and group classes of income?</p> <p>In addition, is there discretion to enable separate classes of income to be and distributed to different beneficiaries in such proportion as the trustee decides?</p>	<p>A broad review of the trust deed to ensure there are sufficient streaming provisions should be undertaken.</p> <p>Where no streaming provisions are present and the trust is in receipt of dividends and capital gains in addition to other sources of income; then steps may be taken to update the deed prior to any distribution being made (provided appropriate powers are exercised within any timeframes).</p>



Is there a power to accumulate income?	Absent this power, income would have to be distributed to beneficiaries.
Are there limitations on how the trustee may distribute income?	Some trust deeds may impose a 39% cap on distributions to certain classes of beneficiaries or may limit distributions to foreign persons.
Is consent or notice required when making income distributions?	Some trust deeds may require written 'Appointor' or 'Guardian' consent . We have identified deeds requiring such consent up to 14 days prior to distribution.
When must income distributions be made by?	Some trust deeds may require a distribution before 30 June.
Can distributions be orally recorded?	It is best practice, regardless of whether the deed allows it, to subsequently document oral distributions in writing and some trust deeds require oral declarations to be formalised by way of statutory declaration.
Is there a power to carry forward losses (e.g. the trustee is not required to utilise losses if not suitable)?	See paragraph 2.29 above.
Is there a power to offset income with previous year losses?	Consider whether the trust loss rules are met.
How are unpaid present entitlements treated?	Some trust deeds include provisions that cause an unpaid present entitlement to be converted into a loan.
Can the trustee make capital distributions prior to vesting?	Older trust deeds may not necessarily include a power to make distributions of capital prior to the vesting of the trust. This is particularly of concern where Distributable Income is defined in a manner that does not include capital gains.
Are there restrictions on making capital distributions?	Some trust deeds may include restrictions on how capital distributions made by made.
What happens to any income not distributed or accumulated under a trustee's discretion?	If a valid trust distribution resolution is not prepared, it should be known who receives such income by default (or if the income is accumulated at the top marginal tax rate).
How is the income to be distributed (by way of specific amount or percentage)?	It is not recommended to distribute income with reference to the recipient's taxable



	<p>income (known as a 'reverse engineered' distribution). This option is not recommended in the context of the ATO's concerns outlined at issue 1 of TD 2012/22EC.</p> <p>Specifically, there are potential arguments that such clauses may be challenged as being uncertain and ineffective. This is especially the case where elections and choices may be made after the trustee distribution resolution making it unreasonable to knowingly have any present entitlement at the date of the trust distribution resolution.</p>
<i>The Why of Trust Distributions</i>	
Is there a distribution to a company?	Consider the operation of Division 7A and TD 2022/1.
Is there a distribution to an adult child or related family member not commonly involved within the family group?	Consider the operation of section 100A.
If a business is operated from the trust or from a company which the trust is a shareholder, will the distribution impact on who is considered 'connected with' the trust?	Consider if the recipient will cause difficulty in meeting any future MNAV Test or Turnover Test.
If a business is operated from a unit trust or company which the trust is a shareholder, will the distribution impact on who is a significant individual?	Consider any 'split' distributions of income and capital may affect there being a significant individual.
If losses are made in the trust, will the distribution impact on the ability to make a family trust election?	Consider if making distributions to persons outside the definition of 'family group' will impact the availability to access losses in the future.
If a family trust election has been made, will the distribution be within the family group?	Consider if Family Trust Distribution Tax will apply.
<i>The How of Trust Distributions</i>	
Has the trustee exercised 'real and genuine' consideration at the time of making the trust distribution	Failure to do so may enable challenges again a trust distribution by a disgruntled beneficiary.



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11 Disclaimer

- 11.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

12 Contact details

Author	Darius Hii, Director
Firm	Chat Legal Pty Ltd ABN 64 621 391 553
Direct line	0403 923 374
Email	darius@chatlegal.com.au